BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN id. AND BLANCHE NICHOLS)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal, income tax against John W. Nichols in the amounts of $581.73 and $1,107.39, for the years 1951 'and 1952, respectively, against Blanche Nichols in the amounts of $581.73 and $1,107.39 for the years 1951 and 1952, respectively, and against John W. and Blanche Nichols jointly in the amounts of $2,494.23, $3,021.73 and $1,693.38 for the Years 1953, 1954 and 1955, respectively.

Appellant John Pd. Nichols (hereafter referred to as Appellant) conducted a coin machine route, placing his machines in location such as bars and restaurants. Throughout the years under appeal Appellant owned music machines, shuffle alleys, amusement rides and a flipper pinball machine. In addition, he owned eight or nine multiple-odd bingo pinball machines beginning in 1953. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Appellant and the location owner.

During 1951 and 1952, Appellant also owned a claw machine, The claw machine was turned over to and operated by a Hugh Davies who dealth with the owner of the location in which it was placed, and Appellant received 50 percent of the income retained by Davies.

During 10 weeks in the autumn of 1951, Appellant operated a weekly betting pool, the winners being determined by the outcome of college football games played on Saturdays. Appellant had football pool tickets printed and these were sold at about 20 locations. Each location owner retained 15 percent of the total

amount taken in on the sale of the tickets and Appellant made all the payouts out of his 85 percent share.

The gross income from Appellant's coin machine route as reported in Appellant's rax returns was the total of amounts retained from locations. Deductions were taken for depreciation, salaries, cost of phonograph records and other business expenses.

Respondent determined that Appellant was renting space in the locations where his machines were placed and that all of the coins deposited in the machines constituted gross income to him. Respondent also disallowed all expenses relative to the coin machine route, pursuant to Section 17297 (formerly 17359) of the Revenue and Taxation Code which reads:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

With respect to Appellant's coin machine route, the evidence indicates that the operating arrangements between Appellant and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197,3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of these machines is, accordingly, applicable here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1942, CCH Cal. Tax Rep. Par. 201.984, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code Sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games and we also held bingo pinball machines to be predominantly games of chance.

The evidence indicates that it was the general practice to pay cash to players of Appellant's bingo pinball machines for free games not played off. Accordingly, the bingo pinball phase of Appellant's business was illegal, both on the ground of ownership and possession of bingo pinball machines, which were predominantly games of chance, and on the ground that cash was paid to winning players. Respondent was therefore correct in applying Section 17297.

There were no records of amounts paid to winning players on bingo pinball machines, and in order to reconstruct the gross income Respondent estimated these unrecorded amounts as equal to 47 percent of the total amounts deposited in the machines. Respondent's auditor testified that the 47 percent payout figure was based upon actual payouts shown on four collection slips. The auditor further testified that during an interview in 1956 Appellant told him that payouts averaged about 40 percent of the amounts in the machines. At the hearing of this matter Appellant estimated that payouts averaged about 30 percent while a location owner indicated that payouts constituted more than half of the amounts in the machine.

As we held in Hall, supra, Respondent's computation of gross income is presumptively correct. The 47 percent payout figure seems reasonable and under the circumstances will not be disturbed.

In connection with the computation of the unrecorded payouts, Respondent's auditor estimated that 10 percent of Appellant's recorded gross income from the coin machine route was attributable to the bingo pinball machines during 1952, 1953, 1954 and 1955. Since there is no evidence to the contrary, we will not disturb this estimate for the years after 1952. However, Appellant testified that he first acquired bingo pinball machines in 1953 and this is supported by the fact that his reported gross income from his coin machine route increased significantly in that year. We conclude that there was no illegal activity with respect to the coin machine route prior to 1953.

With respect to the claw machine, Respondent determined that Appellant operated the machine and that all of the coins deposited in it were includible in his gross income. However, the evidence indicates that Appellant leased the machine to Hugh Davies for 50 percent of the income retained by Davies and had nothing to do with its operation. Consequently, the only income from this machine which is taxable to Appellant is the rental income in the amounts of $955 and $835.75 for the years 1951 and 1952, respectively.

With respect to the football pool, that operation clearly violated Section 337a of the Penal Code which makes it illegal to engage in "pool-selling" or to receive or make wagers on a contest between men. Respondent% auditor testified that Appellant told him during an interview in 1956 that the gross income from the football pool must have approximated $2,500 in order for him to have earned the $873 which he reported. The $2,500 figure is supported by Appellant's testimony that half of the gross was paid to winners and 15 percent to the locations where the tickets were sold. We conclude that Respondent correctly applied Section 17297 and attributed the $2,500 in income to Appellant without deductions.

Except for the cost of certain machines purchased for resale, Respondent disallowed all of the business expenses attributable to the coin machine route for each of the years under appeal. We are of the opinion that under a reasonable interpretation of Section 17297 the overall operation of the coin machines did not tend to promote or further, and was not connected or associated with, the illegal activities. The football pool was operated for only 10 weeks and although football tickets were sold at some of the locations where Appellant had coin machines the connection of the football pool with the coin machine route appears inconsequential. The claw machine, assuming that its ownership was illegal, was rented to an operator and appears to have had little or no connection with the coin machine route. The evidence indicates that during 1953,1954 and 1955 Appellant had amusement machines at between 80 and 113 locations while he placed only eight or nine bingo pinball machines. The predominance of the amusement machines is further reflected by Respondent's estimate that only 10 percent of the Appellant's recorded machine income was attributable to the bingo pinball machines.

We believe, however, that the operation of amusement machines in the same locations with bingo pinball machines did tend to promote or further and was connected or associated with the illegal activity of operating bingo pinball machines. The evidence indicates that there were four or five locations which had amusement machines together with bingo machines.

Accordingly, the expenses to be disallowed are all expenses of the bingo pinball machines and all expenses of amusement machines in the same locations with bingo pinball machines. In the absence of evidence of the exact amount of expenses, we believe that 15 percent of the total expenses of the coin machine route during 1953,1954 and 1955, respectively, would reasonably reflect the expenses of the bingo pinball machines and the expenses of amusement machines placed in the same locations with the bingo machines.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests to proposed assessments of additional personal income tax against John W. Nichols in the amounts of $581.73 and $1,107.39 for the years 1951 and 1952, respectively, against Blanche Nichols in the amounts of $581.73

and $1,107.39 for the years 1951 and 1952, respectively, and against John W. and Blanche Nichols jointly in the amounts of $2,494.23, $3,021.73 and $1,693.38 for the years 1953, 1954 and 1955, respectively, be modified in that the gross income and expenses are to be recomputed in accordance with the opinion of the Board. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 7th day of August, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake, Member

Richard Nevins, Member

Geo. R. Reilly, Member

_____, Member

ATTEST: F. H. Freeman, Secretary